

China's Economy and Market

Hongbing Deng

The past 30 years have witnessed an unprecedented development – the explosive economic growth and industrial expansion of China. China has achieved an average of 10% growth rate since 1979, the year after Deng Xiaoping set China on the economic reform path. This has lifted hundreds of millions of people out of poverty and brought China from absolute poverty to the level of a moderately prosperous country, though still poor on per capita terms. Cities such as Beijing, Shanghai and Guangzhou, having gradually dilapidated before the economic reform, have been transformed into megacities that number among the most modern in the world. Shenzhen, a small fishing village, has become an advanced metropolis with a population of 9 million.

Hopefully what follows here can help

Connecticut based and American based companies in general to gain a better understanding of China's economy and market. Some statistics from 1979 in contrast to the present are used for comparison to illustrate how China has evolved over the past 30 years.

Those interested in penetrating or investing in the Chinese market first need to know how vast China's economy and market really are and must recognize how rapidly the economy is evolving. Some recent headline news provides us with a better appreciation of this:

- China has passed Japan to become the second largest economy in the world.
- China has surpassed Germany to become the No. 1 exporter in the world.
- China's foreign currency reserve

Biography

Hongbing Deng is the Founder and Vice President of AnMar, a trading company specializing in Chinese pharmaceuticals. Mr. Deng worked in the business sector in China prior to coming to the United States and starting his own business here. He is a graduate of the Yale School of Organizational Management. A frequent traveler between the United States and China, in 2009 AnMar was chosen by the Connecticut Department of Commerce as the most successful small business in the state.

reached 2.65 trillion as of the end of September, 2010 compared to only \$850 million in 1979.

- China's energy consumption has surpassed America's to become No. 1 in the world, a position that the United States had held for more than a century.
- China will overtake America to become the largest manufacturer in the world in 2011, a title America has held for 110 years. Interestingly, China is winning back this posting, having had been the world's largest manufacturer for more than 1,500 years until it ceded its position to the United Kingdom in the mid 19th century. The United Kingdom's manufacturing in turn was eclipsed by America at the end of the 19th century.

A country's economy is usually measured in terms of its GDP (Gross Domestic Product), either by nominal US dollars or by PPP (Purchasing Power Parity). GDP has four components: private consumption, government spending, capital investment and foreign trade (export minus import).

The following are a few staggering numbers which demonstrate the changes of China's GDP over the past three decades:

- China's foreign trade has increased one hundredfold in the past 30 years, from \$29.3 billion in 1979, or about 1% of world trade volume, to \$2.97 trillion, or 10% of world trade share, in 2010.
- China is now the world's largest exporter and the second largest importer.
- Bilateral trade between the United States and China reached \$366 billion in

2009 from almost zero in 1979.

- America and China are now each other's third largest trading partners.
- The China-based operations of American companies reached \$100 billion in sales in 2009.



Night view of Shanghai

China's infrastructure, among the most backward in the world 30 years ago, is now ahead of many developed countries. The massive infrastructure building still shows no signs of abating. China's highway network, totaling 40,000 miles at the end of 2009, is now second only to the United States', with 50,000 miles, and is expected to exceed that figure within three years.

China's population, continental size land-mass, and the increasing mobility of its citizens give China a huge advantage in the development of high speed trains. China now has the most sophisticated high speed railway network in the world, with most of it having been developed in the past decade. China also has plans to extend its high speed rail network to Southeast Asia in the coming years, eventually linking Singapore with London in a

rail travel time of 48 hours.

China also now has seven of the ten longest bridges in the world. The Hangzhou Bay Bridge, with a length of 22.2 miles, is currently the second longest sea bridge in the world. The Qingdao Bay Bridge, only recently completed, is now the longest, spanning 26.4 miles. Also, now six of China's seaports number among the ten busiest in the world with Shanghai Port first on the list in terms of both cargo tonnage and TEU (twenty-foot equivalent units), having just exceeded Singapore in 2010.

Shanghai's metro system, with the first line built in 1995, now has 260 miles in operation and has surpassed New York to become the most extensive system in the world. The Shanghai metro system is expected to reach 540 miles by 2020, more than doubling its current total length. Shanghai also operates nearly 1,000 bus lines, compared to only 100 lines in 1979. The Shanghai bus system likewise now ranks as the most extensive network of its kind in the world.

To feed its speedy industrialization, urbanization and infrastructure building, China now produces 47% of the world's steel, which is greater than the total output of the next 19 largest steel-producing countries combined. It also produces 50% of the world's cement, 60% of its aluminum and 45% of its coal. The rapid industrialization has exerted huge pressure on China's environment and resources. According to a World Bank study from a few years ago, China is home to 16 of the world's top 20 most

polluted cities.

For those interested in marketing products or in investing in China, some other questions naturally come to mind such as: Is China a rich country, or is China a poor country? What products does China need? Can China afford the products that our firm would like to market? Which market segment should our firm target?

Most Chinese, whose annual per capita income only reached \$283 per year in 1979, lived in absolute poverty. China did not provide a market for the products that most of the outside world would have liked to have made available in



Red lantern and skyscraper with blue sky in Beijing Central Business District

China at that time. What China had was only a potential market. Multi-national consumer companies repeatedly had lofty dreams of every Chinese buying one piece of their product. Today, such a dream is not only feasible-it is being realized.

China's per capita GDP reached \$3,700 in nominal terms and \$6,800 in PPP in 2009, a thirteen fold increase in 30 years. These numbers still appear low, ranking about 100 in the world in terms of PPP. To determine whether China is still too poor to buy your products, average numbers can be very misleading. China has a very uneven wealth distribution. Furthermore, government statistics often underestimate the real income. Many multi-national corporations drew the wrong conclusion and later regretted that they had lost a competitive edge against their more savvy competitors who did enter the Chinese market earlier in the process.

A good example was Yum! Brands, the parent company of the KFC, Pizza Hut and Taco Bell fast food restaurant chains. In spite of repeated courting from the city government of Nanchang, the capital of Jiangxi Province and a second tier city in China, both Yum! Brands and McDonalds balked on investing in Nanchang. Government statistics showed that Nanchang's per capita income in 2000 was 2000 Yuan, which was deemed too low in affordability by both companies, given that a typical meal from those chains costs more than 20 Yuan per person. KFC finally decided to open its first restaurant in August 2000 and it prepared to lose money for at least 3 months. On opening day, KFC put up a huge poster with the words: "Our sincere apologies to

Nanchang people; we are late." Nanchang people were very forgiving. The line was six-tenths of a mile long and KFC set a worldwide single day sales record that day and that record continued being broken for 23 consecutive days.

One of the biggest negative issues in China's economic development is the expansion of the Gini coefficient, the measure of income distribution in which zero indicates perfect equality. China's Gini coefficient reached 0.47 in 2009, placing China among the countries with the widest gap between their rich and poor.

It is estimated that out of 1.3 billion Chinese people, 150 million still live in poverty (i.e. under \$1 a day), 250 million live between \$1 and \$2 a day and another 400 million are in a low income class with limited purchasing power. The middle class population reached 350 million in 2010 (50,000 Yuan annual income, or about \$7500 dollars in nominal terms and \$14000 based on PPP). The upper middle class reached about 100 million. The wealthy class is estimated at 40 million now and is likely to reach 160 million in 5 years. At the top of the pyramid are 10 million very wealthy people, 900,000 millionaires and about 200 billionaires (both in U.S. dollars), second only to America.

The past few years have witnessed a rapid accumulation of wealth in China, with the total net worth now exceeding \$16.6 trillion, placing it No. 3 in the world, after America's 54.6 trillion and Japan's 21 trillion. Even excluding those living in poverty and low income families, China's market size and purchasing power stands among the highest in the world, with 500

million people in the middle and wealthy classes.

Another tremendous income source is the “grey income.” Though every country has the phenomenon of “grey income,” China could be the most dramatic case because of its rapid economic expansion and the serious corruption that exists in business activities. According to a Credit Suisse study, China’s grey income amounted to a stunning \$1.4 trillion in 2008, or about one third of China’s GDP in that year. About 80% of the grey income is concentrated in a small group of wealthy people, which bodes well for the luxury goods market.

China’s consumption-to-GDP ratio, currently at 36%, is only half that of the U.S. and about two-thirds those of Europe and Japan. But that is about to change. Recent statistics show that private consumption in China is expanding at about 15% a year, much faster than the rate of overall economic growth. The ratio can reach above 50% of GDP by 2025, adding \$1.9 trillion to global consumption, according to a recent report by McKinsey, a management consulting concern. As a matter of fact, many products catering to the middle class and wealthy class have already seen their sales in China exploding in recent years.

Yum! Brands’ KFC unit opened its first restaurant in China in October 1987 at Beijing Qianmen, its largest restaurant in the world with more than 500 seats. The cost of a typical meal per person was about one week’s income for a Chinese worker at that time. Many Chinese tried it

once but were not return customers. KFC had to rely on foreign tourists for its business. Less than 5 years later, the restaurant was enjoying such good business that it had to expand by adding 200 seats. Now KFC already has 3200 restaurants in China. On average it is opening 1.5 new restaurants every day in China. During the second half of 2010, China surpassed Yum! Brands’ US market to become its largest market in total sales. Yum! Brands expects its revenue from China to be more than double that of the United States by 2015. Avon entered the Chinese market in the late 1980s. Sales reached \$4 million in the first year, 3 times what had been projected. That figured doubled in 1992. It doubled again in 1993 and reached \$40 million in 1995 and \$200 million in 2000.

When Deng Xiaoping visited the United States in 1979, he toured a Ford plant in Atlanta. The output of that plant in a single month outnumbered the total automobile sales in China at that time. In 2009 China’s automobile sales reached 13.5 million units, surpassing the U.S. to become the largest market in the world, or 25% of the world total unit sales. Sales jumped another 33% in 2010 to reach 18 million units. GM sold 2.35 million cars in China in 2010, a 28.8% increase over 2009. China is now GM’s largest market, surpassing its US market, which had been GM’s largest for 102 years.

The breakneck development of car ownership and the growing freight traffic over the past few years have resulted in constant traffic jams in major Chinese cities and highways, often among the worst in

the world. Last August, China set a record for traffic jams by having one that lasted for more than 20 days and extended for 60 miles on the Beijing Tibet Highway in a section close to Beijing.

Luxury products sales in China grew 20% in 2009, enabling China to overtake America to become the No. 2 luxury market in the world after Japan. With sales increasing another 30% in 2010, China is expected to be the largest luxury goods market by 2013. German luxury car makers have been extremely successful in China. Total sales of the three luxury brands of Mercedes, Audi and BMW in China exceeded those of the United States for the first time in 2010. China is likely to surpass the German home market in 3 to 5 years for these brands, if not sooner.

Both Coach and Tiffany, seeing their business exploding in China, are aggressively opening stores in China. 10% of Coach's revenue was from China in 2010. Coach predicts China's share to be 20% by 2013. Casino revenue in Macau, \$23.5 billion in 2010, outshined that of Las Vegas by a significant margin. In 2010 nearly 1 million Chinese tourists visited America. With an annual family income of between \$45,100 and \$79,300, these visitors spent \$7200 on average per person during these visits.

China's service industries, at 42.6% of GDP, are most likely underestimated, especially in PPP terms, as government statistics do not capture many cash transactions. The restaurant business has been booming for many years in major cities as

restaurants are often favored places for business meetings and for nurturing relationships. Multi-story restaurants in big cities like Beijing, Shanghai and Guang-



Service industry, Chengdu Sichuan Province, China

zhou contain a hundred or more dedicated private rooms and huge halls on each floor. Some restaurants even have waiters and waitresses roller-skate to serve tables.

A fast aging population has created a huge household service market in major cities. There are more than 1 million live-in housemaids in Shanghai alone, in addition to part-time cleaners, cooks and hospital overnight maids. The well-know Big Mac index measures the purchasing power in different countries for a single product. The most recent study shows that a Big Mac costs \$3.71 on average in America and about \$2.20 in China. The conclusion would appear to be that Chinese currency is 40% undervalued, as claimed by many economists and politicians. One of the most underpriced services in China is actually the haircut. A basic haircut costs 10 Yuan or about \$1.5 in Shanghai at a decent hair salon. The same haircut costs \$6 in New York's Chinatown. If a haircut index rather than a

McDonalds index were in existence, politicians such as Senator Charles Schumer could claim that the Chinese currency was in fact 75% undervalued.

Every 30 years is considered a mini cycle in China. A witty folk saying has demonstrated how China has changed over the past 60 years, both economically and ideologically. It goes like this: In 1949 only socialism can save China, in 1979 only capitalism can save China and in 2009 only China can save capitalism.

We are never lacking in predictions regarding China's future development. The boldest prediction could be from Robert Fogel, a Nobel Prize laureate from the University of Chicago. He predicts that China's economy will reach \$123 trillion by 2040, or \$85,000 per capita. Many pessimists, on the other hand, predict China will eventually collapse or even disintegrate, as they claim China's economy and political system are not sustainable.

No matter which eventuality plays out in coming years, one thing is certain: China is not a country of status quo but of constant change, and that change cannot be taken lightly.